7300 PAYROLL FACTOR

The numerator of the payroll factor is the compensation considered to be paid in this state under the tests described in MATM 7370. The denominator is the total compensation paid everywhere during the taxable year (R&TC §25132.) The payroll must be incurred in the unitary trade or business -- compensation related to nonbusiness activities is excluded (CCR §25132(a)(2)).

Reviewed: December 2002

7310 RECONCILIATION OF PAYROLL FACTOR

Denominator
If the tax return contains enough detail, it is generally a good starting point for testing the reasonableness of the denominator. Payroll expense on the Form 100 or Federal Form 1120 is most commonly found on line 12 (Compensation of Officers), line 13 (Salaries and Wages), and as a component of cost of goods sold or overhead. Foreign payroll is sometimes identified in the financial statements attached to the Form 5471 (*Information Return of U.S. Persons With Respect to Certain Foreign Corporations*). The SEC 10-Ks will sometimes contain detailed employee information that may also be helpful in reconciling the denominator. Material differences between the denominator of the payroll factor and the payroll identified on the tax returns or 10-Ks should be flagged for further investigation. The auditor should keep in mind, however, that valid differences do sometimes occur (see MATM 7340, *Cash vs. Accrual*; MATM 7350, *Capitalized Payroll*).

Auditors should generally request the Federal Forms 940 (Em*ployer's Annual Federal Unemployment (FUTA) Tax Return*) or 941 (*Employer's Quarterly Federal Tax Return*) to verify domestic payroll. (Copies of these forms are shown at Exhibit D.1 and Exhibit E.1.) Compensation reported on Forms 940 and 941 is usually determined in the same manner as for payroll factor purposes, although some adjustments may have to be made to account for cash vs. accrual differences (MATM 7340).

In cases where the payroll factor has been computed on an accrual basis or where the taxpayer's fiscal year-end does not coincide with the end of a quarter, the auditor may or may not be able to reconcile the payroll factor to the payroll tax returns. Even if such a reconciliation is not possible, the auditor can compute the ratio of California payroll to Total payroll per the payroll tax returns. Used in conjunction with the reconciliation of payroll in the denominator to the tax returns, this ratio will allow the auditor to determine the reasonableness of the reported payroll factor.

Example
Assume that the taxpayer has a 4/30/xx year-end, and the auditor is not able to verify the payroll using the quarterly Forms 941. The California payroll tax returns (DE-6's) and the Federal Forms 941 for the 12 months ending 3/31/xx disclose payroll of $5,000,000 and $8,000,000 respectively, for a California percentage of 62.5% (the taxpayer has no foreign payroll). Although the actual amounts in the payroll factor will vary between the 3/31 and 4/30 year-ends, the percentage can be expected to remain relatively stable. Therefore, by comparing the 3/31/xx percentage of 62.5% to the 4/30/xx payroll factor percentage as filed, the auditor can determine whether the factor appears reasonable.

When using this technique to test the reasonableness of the payroll factor, the auditor should be alert for circumstances that may prevent the percentage constructed from the payroll tax returns from being representative of the actual payroll factor. Such circumstances may include large bonuses paid at year-end, the acquisition/disposition of a subsidiary, or a material fluctuation in the workforce (such as a strike) occurring at either the beginning or end of the period.

Numerator:
California payroll tax returns (Form DE-6) are filed quarterly with the Employee Development Department (EDD) (see Exhibit F for a copy of the Form). As with the Federal Forms 940 and 941, compensation reported on Form DE-6 is generally determined in the same manner as for payroll factor purposes (although some special industry formulas may source payroll differently, see MATM 7700 et al.). Since taxpayers are required to track payroll data for each state for unemployment tax purposes, by-state payroll records should also be available to verify California payroll. If by-state records are used, the auditor should verify that the total for all states reconciles to the denominator of the factor to ensure that all compensation is accounted for.

Reviewed: December 2002

7320 COMPENSATION DEFINED

For payroll factor purposes, the term "compensation" means salaries, wages, commissions and any other form of remuneration paid to employees for personal services (R&TC § 25120(c); CCR §25132(a)(3)). To the extent that the value of board, rent, housing, lodging and any other benefits or services provided to employees constitutes taxable income to the employee under the Internal Revenue Code, such amounts are included in the definition of compensation. Generally, this will be the same amount of compensation that is reported for unemployment and payroll tax purposes.

Reviewed: December 2002

7321 Deferred Compensation (401k Plans)

Although deferred employee compensation items (such as 401K plans) are not taxable to employees until some future date, such compensation is generally expensed by the employer in the year paid or accrued (IRC §404). The department's policy is to include such deferred compensation in the payroll factor in the year that it is expensed by the employer. Deferred compensation is reportable on the Federal Form 940 (since 1984) and the California Form DE-6 (since 1985), so the reconciliation of the payroll factor to these payroll reports should verify whether it has been picked up in the factor. Verifying the inclusion of 401K amounts through reconciliation to a Form 941 is a bit trickier: Since deferred compensation is not included in the employees taxable wages, it is not included on the Form 941 line entitled "Total wages and tips subject to withholding." Deferred compensation is included on the Form 941 lines entitled "Taxable social security wages" and "Taxable Medicare wages and tips." (See Exhibit E.1 for a copy of the form.)

Reviewed: December 2002

7322 Stock Options

Employees sometimes receive stock options as a form of compensation. Stock options give the holder the right to purchase shares of the corporation at a fixed price on a specified date or within a specified period of time. The options are generally classified as either nonqualified or qualified. Qualified stock options are options meeting the requirements of IRC §422 or IRC §423. Options not described under those sections are termed nonqualified stock options. The payroll factor implications of granting stock options will vary depending upon the type of option:

Nonqualified options with a readily ascertainable fair market value (as defined in Treas. Reg. §1.83-7(b)): The difference between the value of the option and its cost (if any) to the employee is taxed to the employee and deducted by the employer at the grant date. The same amount would be considered to be compensation includable in the payroll factor for the period in which the option was granted. In all practicality however, options seldom have a readily ascertainable fair market value.

Nonqualified options without a readily ascertainable fair market value: Taxation is not triggered until the option is exercised. The amount of compensation recognized by the employee and deducted by the employer will be the value of the stock at the exercise date, less any amounts paid for the stock or the option. Since the compensation is considered to be received at the exercise date, that is the period in which the compensation will be included in the payroll factor. Since this is also the treatment reflected on the Federal Forms 940 and 941, and the California Form DE-6, no special problems should arise with respect to identifying or reconciling this item for payroll factor purposes.

Qualified options: Neither the grant nor the exercise of qualified stock options is a taxable event for the employee, and no compensation related to such transactions will be included on the payroll tax reports. Furthermore, the employer corporation is not generally allowed a compensation deduction related to such options. Since no compensation is considered to be paid or received, there will be no compensation reflected in the payroll factor. (An exception may occur if there is a disqualifying disposition of stock, in which case compensation may be deemed to occur in the year of the disqualifying disposition (IRC §421 - IRC§423).)

Reviewed: December 2002

7323 Compensation Paid By Another Entity

Frequently, an employee will perform services for which no compensation will be directly received. For example, an individual may be an officer of both a parent corporation and its nonunitary subsidiary (the taxpayer). Although the individual performs services for the subsidiary in his or her capacity as an officer/employee, the parent pays the officer's entire salary. Since the subsidiary does not actually pay compensation for the services, no salary will generally be included in the subsidiary's payroll factor. [An exception to this rule might occur if the compensation was clearly related to services performed for the subsidiary, in which case the salary paid by the parent might be deemed to be a contribution to the capital of the subsidiary, and constructively paid by the subsidiary to the employee. An example of this type of situation may be found in Rev. Rul. 84-68, 1984-1 CB 31.]

Reviewed: December 2002

7330 EMPLOYEE DEFINED

The term "employee" is defined in CCR §25132(a)(4) as any officer of a corporation, and any individual who has the status of an employee under common-law rules. Generally, an employment relationship exists when the corporation for whom the services are performed has the right to control and direct the individual who performs the services, not only as to the results to be accomplished, but also as to the details and means of accomplishing that result (Coleng v. Ramsdell, 19 Cal.App.2d 376).

In the *Appeal of Lipps, Inc*., Cal. St. Bd. of Equal., March 3, 1987, the taxpayer contracted for an unrelated company in Mexico to provide the labor and facilities to assemble the taxpayer's products. The taxpayer paid the Mexican company a fee pursuant to the production contract, and the Mexican company in turn paid the workers. The taxpayer included the wages paid to the workers in its payroll factor. The SBE held that since the compensation was not paid *directly* to the workers by the taxpayer, it was not includable in the payroll factor. Moreover, the SBE found that the workers were not employees of the taxpayer under the common law definition. The most important aspect of an employee relationship, the right to control the manner and means of accomplishing the desired results, was found to be lacking in this case.

In most cases, if a person is considered to be an employee for payroll tax or unemployment tax purposes, they are also considered to be an employee for apportionment factor purposes. Therefore, unless the auditor has reason to believe that persons included on a correctly completed Federal Form 940 or 941 or California Form DE-6 are not true employees under common law, we will generally accept the payroll reported on those filings.

Reviewed: December 2002

7335 Employees vs. Independent Contractors

Only compensation paid to employees is included in the factor. Amounts paid to agents, brokers and other independent contractors are excluded. Agents and brokers receive gross commissions or fees from which they must pay their own expenses such as travel, entertainment, rent, telephone, etc. There is therefore no reasonable comparison between compensation paid an employee and a commission paid an independent contractor. Including such commissions in the payroll factor would unduly weight the numerators of those states where agents or brokers are located.

For an exception to the rule that fees paid to independent contractors are not included in the factor, see the special formula for Film Producers, MATM 7740.

Since commissions or fees paid to independent contractors are not included in the Federal Forms 940 and 941 or the California Form DE-6, the reconciliation of payroll to those sources will generally disclose whether material payments to U.S. independent contractors have been included in the factor. Some taxpayers conduct their foreign marketing and distribution activities through agents. If the combined report includes foreign payroll, the auditor should consider determining whether the recipients of these payments are actually employees. The SEC 10-Ks will sometimes contain detailed employee information that may be helpful in identifying this issue.

Reviewed: December 2002

7340 CASH vs. ACCRUAL

Under the general rule stated in CCR §25132(a)(2), the payroll included in the factor should be determined on the basis of the taxpayer's accounting method. Since most multistate taxpayers use the accrual method of accounting, the payroll factor should reflect compensation accrued during the period. For unemployment compensation purposes however, most states require corporations to file their payroll tax returns on the cash method even though their books are kept on the accrual method for other purposes. Many corporations therefore maintain their by-state payroll records on a cash basis. Recognizing this fact, CCR §25132(a)(2) allows taxpayers to elect to report compensation using the cash method for payroll factor purposes.

If the cash method is used, the auditor should verify that it is used consistently for both the numerator and denominator.

If the taxpayer computes its payroll factor using the accrual method, it is still possible to reconcile the payroll factor to the cash basis payroll tax reports by analyzing the opening and closing accrual adjustments. These adjustments are usually made on the general ledger trial balance. Even if a thorough reconciliation is not possible, the payroll tax reports may still be useful for testing the reasonableness of the payroll factor as explained in MATM 7310.

NOTE: Use of the cash method is an election of the taxpayer. If the taxpayer does not wish to report compensation under the cash method, the auditor may not require use of that method. If the payroll amounts reported by the taxpayer do not appear to be reasonable and the auditor is unable to verify the figures, it is generally acceptable to substitute the "as reported" payroll with amounts from the Forms DE-6 and 940/941, but the taxpayer should be given the opportunity to provide the appropriate accrual adjustments. This adjustment should only be made when the discrepancies are material and the auditor is unable to verify the accrued payroll; it should not be viewed as a routine adjustment.

Reviewed: December 2002

7345 COMPENSATION ATTRIBUTABLE TO NONBUSINESS INCOME

Compensation paid to employees for services rendered in connection with nonbusiness activities is excluded from the payroll factor (CCR §25132(a)(2)). If the taxpayer has nonbusiness activities, an analysis of the related nonbusiness expenses should be made (see MATM 4060). Any payroll expenses allocable to the nonbusiness activity should be eliminated from the payroll factor.

Reviewed: December 2002

7350 CAPITALIZED PAYROLL

Compensation is included in the payroll factor in the year that it is paid or accrued by the taxpayer, even if the compensation has been capitalized rather than expensed. CCR §25132(a)(2) Example (A) describes a situation where the taxpayer's employees are used in the construction of a storage building which, upon completion, will be used in the unitary trade or business. Although the wages paid to those employees are capitalized into the cost of the building, the wages are nevertheless included in the payroll factor.

The Forms DE-6, 940 and 941 include compensation that has been capitalized. If the payroll factor is developed from other sources, the auditor should verify that compensation paid employees for the construction of fixed assets has been included.

Reviewed: December 2002

7355 FOREIGN PAYROLL

Translation of foreign payroll is made at the simple average of beginning and end-of-year exchange rates unless there is a substantial fluctuation in the value of the currency during the year, in which case a weighted average is used (CCR §25106.5-10(c)(2)).

In the case of employees in foreign countries, CCR §25132(a)(3) provides that the determination of whether benefits would constitute income to the employees shall be made as though such employees were subject to the Internal Revenue Code. The payroll costs for some foreign countries will include amounts paid for fringe benefits that would not be taxable to employees under the Internal Revenue Code. Consequently, care must be taken in developing or verifying the payroll for foreign entities in order to ensure that such nontaxable payments are excluded from the factor. Conversely, some payroll items that are nontaxable in the foreign country may be includable in the factor. In Japan for example, bonuses paid to corporate directors are posted directly to equity and are not deducted against income. Such bonuses are included in the denominator of the factor. Several publications are available which summarize the significant accounting principles of various countries (see Exhibit J). Such publications may provide clues regarding what has been included in a taxpayer's foreign compensation.

When auditing a taxpayer with foreign subsidiaries, auditors should be alert for the fact that some taxpayers conduct their foreign marketing and distribution activities through agents or brokers rather than employees. If the combined report includes foreign payroll, the auditor should consider determining whether the recipients of these payments are actually employees. The SEC 10-Ks will sometimes contain detailed employee information that may be helpful in identifying this issue.

If detailed income statements are available for foreign affiliates, they may be used to verify foreign payroll. Often such income statements may be found as a supporting schedule to the Form 5471s (*Information Return of U.S. Persons With Respect to Certain Foreign Corporations*). Translated foreign financial statements may contain notes that are helpful in determining what has been included in payroll expense. Consolidating workpapers to the annual reports may also be used to verify the payroll of foreign entities. Corporations with employees in Canada are required to file a Form T4 (*Summary of Remuneration Paid*), with the Canadian Revenue Department. This form is comparable to the U.S. Form 940 and may be used to test the reasonableness of Canadian payroll. Similar reports used to report payroll to other governmental agencies may also be available, and the instructions to those forms may provide insights as to the types of benefits that are being included in the total payroll figures. As discussed above, auditors need to use caution in relying upon sources such as foreign financial statements or payroll tax returns because of differences that often exist between U.S. and foreign rules for payroll reporting.

If foreign income statements and other sources are not available or do not provide enough detail for reconciliation, the auditor may wish to test the reasonableness of the foreign payroll by performing a ratio analysis (for example, the ratio of payroll expense to sales or cost of goods sold could be examined). Library sources on economic statistics may also reveal information such as average monthly earnings for employees in various countries. The estimates that an auditor can draw from these sources will be very rough, but will provide a starting point if no other information is supplied.

Reviewed: December 2002

7356 Payroll Equalization

Some taxpayers, especially those with operations in low wage economies, may make adjustments to "equalize" foreign payroll expense to reflect equivalent U.S. wage rates. Their position is that $1 of labor in many countries has more earnings potential than $1 of labor in the U.S., therefore distortion is created when the higher California values in the factors pull the income into this state. The U.S. Supreme Court has recognized that this potential for distortion exists, but has nonetheless validated California's system as a fair apportionment scheme on the basis that some degree of distortion is to be expected in any taxation system (*Container Corporation of America v. Franchise Tax Board*, (1983) 463 U.S. 159, aff'g 117 Cal.App3d 988 (1981)). The mere showing that property, payroll or sales in California are higher than in other jurisdictions will therefore not be sufficient to justify departure from the standard formula. (See MATM 7000 for a discussion of distortion in the apportionment formula.) In unusual cases where distortion is believed to be present, the auditor should develop as many facts as possible concerning the activity and labor force in the foreign country. The taxpayer may have internal documents such as staffing reports that will aid in the examination.

Reviewed: December 2002

7360 PARTNERSHIP PAYROLL

If a partnership's activities are unitary with the activities of its corporate partner under established standards (disregarding the ownership requirement), then the partnership's payroll attributable to unitary business activities is includable in the corporation's payroll factor to the extent of their partnership interest (CCR §25137-1(f)(2)).

Example: Corporation A owns a 20% interest in unitary Partnership P and its distributive share of P's income is included in unitary business income. Corporation A's payroll is $1,000,000, and P's payroll is $800,000. For purposes of the payroll factor, A's total payroll shall be $1,160,000 ($1,000,000 plus 20% of $800,000).

Special rules for the apportionment of business income with respect to unitary partnerships engaged in long-term construction contracts may be found in CCR §25137-1(h).

Examination of items making up "Other Income" (line 10 of the Form 1120 return) will usually indicate whether the taxpayer owns partnership interests. The annual reports or SEC 10-Ks may also discuss significant partnership relationships. If the taxpayer has interests in unitary partnerships, the reconciliation of the payroll factor to the Form 1120 return or the Federal Forms 940/941 and California Forms DE-6 should identify whether partnership payroll has been included in the factor. The partnership tax returns (Form 565, or the foreign equivalent) will normally disclose the total payroll amounts. If the partnership operates both within and outside the state, it will normally provide its partners with a schedule disclosing the California property, payroll and sales.

Reviewed: December 2002

7365 OFFSHORE PAYROLL

Offshore payroll issues generally relate to compensation paid to employees working on offshore oil platforms or on ocean-going vessels. Discussion of this issue may be found in MATM 7795 (*Oil & Gas Industry*), and MATM 7760 (*Sea Transportation*).

Reviewed: December 2002

7370 COMPENSATION ASSIGNED TO NUMERATOR

R&TC §25133 provides that compensation is deemed to be paid within this state if any one of the following tests is met:

- The employee's service is performed entirely within the state.
- The employee's service is performed both within and without the state, but the service performed without the state is incidental to the service within the state. In this context, "incidental" is defined to mean any service which is temporary or transitory in nature, or which is rendered in connection with an isolated transaction.
- The employee's service is performed both within and without the state, and
- the employee's base of operations is in this state; or
- there is no base of operations in any state in which some part of the service is performed, but the place from which the service is directed or controlled is in this state; or
- the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state.

The tests are to be applied consecutively. If the first test is not applicable, the second is applied. If the second is not applicable, the third is applied, etc.

CCR §25133 defines the term "base of operations" as the place from which the employee starts his work and to which he customarily returns in order to receive instructions from the taxpayer or communications from his customers, to replenish stock, repair equipment, or perform any other necessary functions. The term "place from which the service is directed or controlled" refers to the place from which the power to direct or control is exercised by the taxpayer.

In *Appeal of Photo-Marker Corporation of California*, Cal. St. Bd. of Equal., November 19, 1986, the issue was whether the compensation of two employees should be included in the numerator. The employees performed services in California for the appellant, but also traveled frequently to New York to perform services in their capacities as officers of the taxpayer's unitary parent corporation. The taxpayer argued that the officers' executive duties in New York were more important and permanent than their jobs in California, and that the base of their operations was at the corporate headquarters in New York. Although the SBE found that the employees' services in New York were more than "incidental," the employees were able to discharge their obligations to the parent by making short-term business trips to New York. Their long-term presence performing services in California led the SBE to hold that the base operations were in this state.

R&TC Section 25133 was patterned after the Model Unemployment Compensation Act, which California has adopted for payroll tax purposes. Therefore, compensation reported to California on

EDD Form DE-6 (*Quarterly Payroll Report*) is generally the same as compensation includable in the numerator of the payroll factor. For situations where the Form DE-6 may include payroll that is not includable in the payroll factor, see MATM 7376 (Expatriate Employees) and MATM 7374 (Payroll in States Where the Taxpayer is Immune From Tax). The workpapers for the Federal Forms 940 will often contain a breakdown by state, which may be used to verify the numerator if the Forms DE-6 are not available.

Reviewed: December 2002

7372 Mobile Employees

The general rules discussed above in MATM 7370 assign the compensation paid to any particular employee to one state, even though the services may have been performed in more than one state. Exceptions exist for employees in certain industries that use special formulas. See MATM 7735 (Air Transportation), MATM 7765 (Bus Lines), MATM 7725 (Commercial Fishing), MATM 7770 (Freight Forwarding Companies), MATM 7760 (Sea Transportation Companies), MATM 7745 (Railroad Companies), and MATM 7755 (Truck Lines).

Reviewed: December 2002

7374 Payroll In States Where Taxpayer Is Immune From Tax

Generally, employee activities sufficient to result in the assignment of payroll to the numerator of the factor will create nexus for California to impose a tax. In accordance with the provisions of Public Law 86-272 however, a corporation will be immune to taxation in a state if its activities within that state are limited solely to the solicitation of sales (see MATM 1200 - MATM 1240 for a discussion of P.L. 86-272). If no member of the combined report has activities within California that exceed the P.L. 86-272 definition of solicitation, any payroll that would otherwise be assigned to California shall be excluded from the numerator of the payroll factor. (Note that in order for payroll to be excluded from the numerator, *no member of the combined report* can be taxable within California. This reflects the "Finnigan" rationale explained in MATM 7530.)

Likewise, the rules for assignment of payroll to the states will sometimes result in payroll being assigned to another state in which all members of the combined report are immune from tax under P.L. 86-272. Since there are no provisions that would allow such payroll to be excluded, it is included in the denominator of the payroll factor even though it will not be included in the numerator of any state ("Nowhere Payroll"). Unlike the sales factor, the payroll factor has no "throwback" provisions allowing the assignment of such compensation to other states.

Reviewed: December 2002

7376 Expatriate Payroll

U.S. executives working in foreign countries who report on a regular basis to their superiors in the United States are often termed "expatriate employees." Although non-residents for California income tax purposes, expatriates from California frequently desire to be covered by the California unemployment and disability provisions. These employees will therefore appear on the Forms DE-6. Since the compensation paid to these employees is not considered to be paid in California pursuant to the rules described in MATM 7370, it is not includable in the numerator of the payroll factor. Wages paid to expatriate employees may be identified on the "Exempt Payments" line of the Federal Form 940 (Part I, Line 2) as wages paid outside of the United States. By comparing a list of the expatriate employees exempted on the Form 940 to the names of the employees whose wages are included on the Form DE-6, the auditor can verify whether such employees have been included in the California payroll.

The presence of expatriate employees as indicated on the Federal Form 940 should also alert the auditor to the possibility of a unitary relationship with a foreign entity.

Reviewed: December 2002